

## TRENDS REINFORCED

Perspective from  
**Franklin Templeton**  
Emerging Markets Equity



# INVESTOR MIGRATION FUELS BRAZIL'S MOMENTUM

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The COVID-19 virus has devastated economies across the globe, including those in Latin America. As the ninth largest economy in the world with a nominal gross domestic product (GDP) of US\$1.84 trillion,<sup>1</sup> Brazil is arguably South America's most influential country. Amid pandemic-induced uncertainty and a sharp decline in domestic demand, Brazil's economy suffered. That said, the country fared relatively well in relation to the wider region, due to generous fiscal stimulus. GDP is expected to decline 4.5% in 2020, but is projected to recover in 2021 and 2022, with GDP growth of 3.6% and 2.6%, respectively.<sup>2</sup>

Despite the economic disruption the global pandemic has caused, we've seen a surge of local interest in equities over the past year, in addition to an increase in initial public offerings (IPOs) since the beginning of 2020.

We observe three underlying domestic factors at play:

- Historically low interest rates have pushed savers into stocks. Wider access to innovative products, along with increased competition among financial technology companies are causing many local investors to migrate from traditional fixed income products into equities.
- Local businesses are riding on a wave of new investors, prompting a surge in private sector investment, gradually replacing the public sector as a growth engine.
- Brazil's growth drivers haven't gone unnoticed. As the investor base grows for Brazil, environmental, social and governance (ESG) considerations are also brought to the forefront. While ESG recognition in Brazil remains in its early stages, it does signal demand for better ESG integration into capital markets.

## OVERLOOKED OPPORTUNITIES

As focus moves from Brazil's recovery to its economic fundamentals, we think the country offers some interesting opportunities that many investors have overlooked. For decades, interest rates in Brazil were in the double digits, but have dropped over the past few years



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and are currently at historical lows (the benchmark Special System for Settlement and Custody [SELIC] rate is currently at 2%). As such, local investors searching for better returns are increasingly turning to other forms of investments, such as equities.

In addition, as businesses become more cognizant of the impact that ESG issues can have on balance sheets, returns and strategic options—and as more investors focus on these issues—we believe that this trend could become an additional support for the Brazilian market through 2021 and beyond.

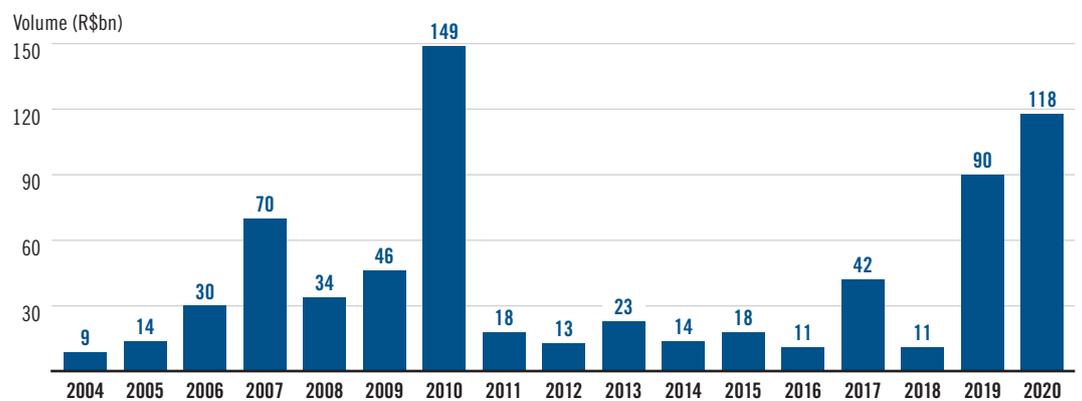
### LOW INTEREST RATES SPUR COMPETITION IN RACE TO THE BOTTOM

A low-yield environment has prompted local Brazilian investors to look into alternative ways of generating returns beyond the traditional bond market.

Current market conditions have changed the behavior of the typical local investor; those who were accustomed to high interest rates—which hovered around 14% between 2015–2016—often had little incentive to invest in stocks.

#### HISTORICALLY LOW INTEREST RATES HAVE PUSHED SAVERS INTO STOCKS

Exhibit 1: Total inflow into equity offerings (R\$bn)  
As of January 2021



In 2010, the Petrobras capitalization was responsible for R\$120bn of the R\$149bn inflows  
Source: B3.

Despite the turmoil COVID-19 caused in the markets, this group of investors is now venturing into equities in droves—the first time for some. In fact, individual retail accounts grew by 94% to 3.2 million during 2020,<sup>3</sup> reflecting a wider change in Brazil’s investment landscape. Equity raised by investors could also encourage a larger wave of IPOs this coming year. Following this trend is a consolidation theme we’ve observed in the health care sector. A prominent chain of hospitals floated on the market to the tune of US\$22 billion in December 2020, in spite of a fall in elective medical care due to the global pandemic. As demand for private health care rises, we think this successful IPO could accelerate a wider trend of consolidation in a fragmented hospital market.

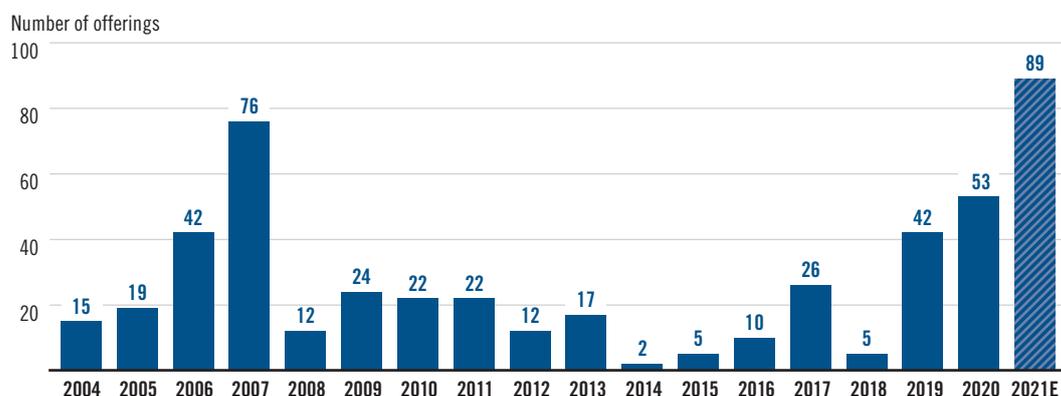
The demographic profile of the average Brazilian investor is also shifting, with younger, less affluent investors participating in the equity market; the average investor is a 32-year-old male on a mid-range income. Male participation dominates the retail stock market, making up 74%. Interestingly, female investors may just be a bit more risk-averse, with a 26% participation in the stock market, compared to a 40% participation rate in the Tesouro Direto, the government-based bond scheme.<sup>4</sup>

Technological advances in fintech companies have removed barriers for everyday investors, broadening access to stocks through digital platforms and mobile applications. In Brazil’s

## A POTENTIAL WAVE OF IPOS COULD ACCELERATE A CONSOLIDATION THEME WE'VE SEEN IN THE HEALTH CARE SECTOR

Exhibit 2: Initial public offerings and follow ons over the past decade in Brazil

As of January 2021



E=estimate

Sources: B3, JP Morgan. There is no assurance that any estimate, forecast or projection will be realized.

competitive brokerage scene, some companies have offered heavily discounted fees—or even pledged to remove them entirely—which has kept Brazil's traditional banks on their toes.

For example, one of Brazil's largest brokerage firms has recently eliminated brokerage fees for its online platform. To be competitive, some investment banks launched new digital platforms of their own. Some traditional banks are also carving out space for digital offerings.

Brazil has a young crop of potential financial customers ripe for the picking. We'd expect this trend to continue as digital investment platforms compete to attract new customers and create loyalty.

## PRIVATE SECTOR INVESTMENT SPEEDS UP

Social-distancing and lockdown measures in the wake of the pandemic have constrained spending in general within the Brazilian economy. Like the rest of the world, however, e-commerce has picked up some of the slack. Notably, Brazil has the fastest-growing number of free-delivery Amazon Prime subscriptions, leading to the creation of several new logistics centers in the country.

Other retail leaders in this space are also snapping up logistic businesses in a bid to expand their own capabilities and leverage these e-commerce opportunities. With a population of 211 million,<sup>5</sup> Brazil has one of the largest consumer groups in the world, and we'd expect this group to become a driving force for continued online-based transactions, even after the pandemic passes. At the same time, technological advancements have made it easier for traditional brick-and-mortar businesses to shift their services online.

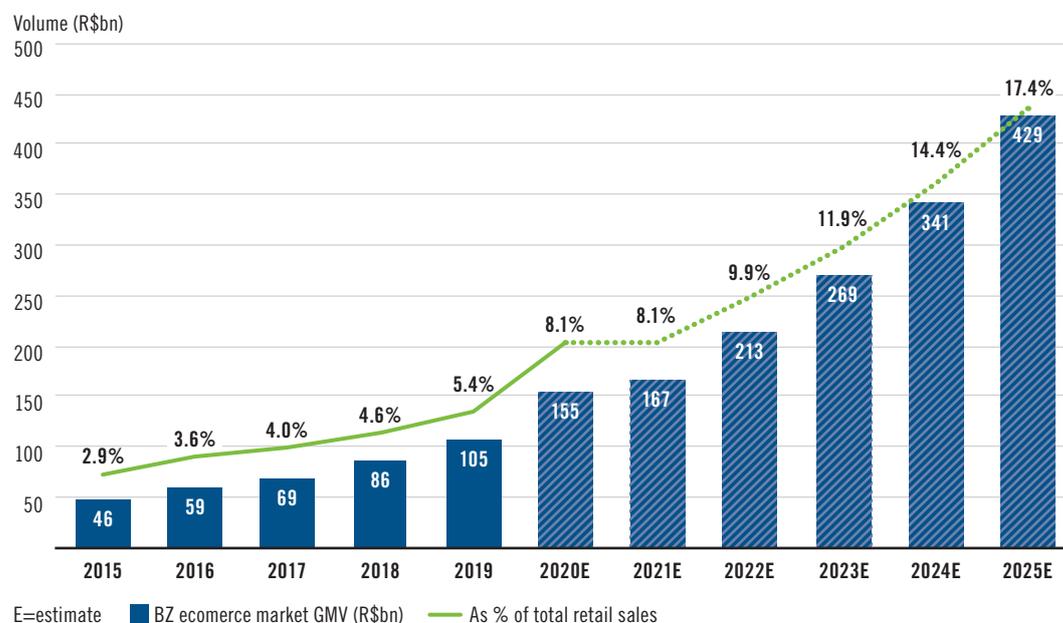
We are also excited at the prospect of a wave of opportunities to come from the privatization of state-run companies in Brazil. The Brazilian government is trying to accelerate an ambitious pipeline of privatizations and partnerships with private companies, but it remains a challenge.

In an attempt to encourage investment and shrink the public sector, the postal service is set to be the first in a string of major privatizations next year, to the tune of 15 billion reais (US\$2.7 billion). President Jair Bolsonaro had previously blocked attempts to sell state-owned banks Caixa Economica Federal and Banco do Brasil SA.

## THE E-COMMERCE SPACE IN BRAZIL CONTINUES TO EXPAND, MUCH LIKE THE REST OF THE WORLD

Exhibit 3: Brazilian e-commerce market gross merchandise volume (GMV) (R\$bn) and share of total retail sales

As of December 2020



Source: BTG Pactual. There is no assurance that any estimate, forecast or projection will be realized.

Brazil's steady privatization program could also make way for environmentally friendly agendas as it seeks to distance itself from issues that have plagued the country in the past, such as deforestation rates, forest fires and river pollution.

## CORONAVIRUS PANDEMIC PUSHES ESG ISSUES TO THE FOREFRONT

Brazil's growth drivers haven't gone unnoticed by foreign investors. Despite the global pandemic, there are encouraging signs that a lively IPO market in the year ahead could attract an increasing number of foreign investors. As the investor base grows for Brazil, ESG considerations are also brought to the forefront.

Brazil has long been vocal on ESG issues, implementing measures through the country's B3 stock exchange to show its longstanding commitment to ESG conventions. In 2005, it launched the fourth sustainability index in the world—the Corporate Sustainability Index (ISE B3)—which came earlier than many of its developed market counterparts. And, in 2010, the Carbon Efficient Index (ICO2 B3) was developed as an instrument to induce the debate of climate change issues in Brazil. While ESG recognition among local investors in Brazil remains in its early stages, it does signal a broader move for ESG integration into capital markets, which we find encouraging.

Many investors across the globe are integrating the information available on current ESG practices into their decisions. Brazil's agricultural sector is a major contributor to the economy—it is one of the world's largest beef exporters. Yet, some investors have highlighted the deforestation tied to beef production as a major ESG consideration.

There have been some positive strides, though. In a bid to tackle large-scale farming, the Low-Carbon Agriculture (ABC) plan offers low-interest loans to Brazil's agribusiness companies who want to practice sustainable agriculture. For example, an agricultural producer reduced running costs for weed detection through infrared cameras in its machinery and prevented the mass use of chemical-based herbicides. Another example is of a Brazilian cattle rancher that shifted to a modern sustainable farming method known as the Integrated System. As a result, farmers can use the soil all year round, find another

use for overgrazed land and expand their herds without deforestation. This approach offers greater diversification for farmers, in addition to year-round employment opportunities for the local community. While significant changes are underway in Brazil's agricultural sector, recovering pastures and reducing chemical use is the first in a long line of the country's climate goals.

The approval of a regulatory framework for Brazil's water and sewage sector is also likely to be a major transformation, and one that could draw in ESG-minded investors. A sanitation bill proposed in 2020 offers to expand water distribution services to 99% of Brazil, up from the current 83%. The approach this bill takes is similar to the way the telecoms industry was previously privatized.

## CONCLUSION

The evidence we've seen suggests Brazil could be gearing up for a year of recovery, with the help of domestic drivers. An influx of new, local investors is likely to drive demand for equities as interest rates remain low in the near to intermediate term. At the same time, increased interest in Brazil's market among foreign investors could spell increased competition among private companies and lead more companies to tackle ESG issues.

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### Endnotes

1. Source: World Bank, 2019.
2. Source: International Monetary Fund, World Economic Outlook, January 2021. There is no assurance that any estimate, forecast or projection will be realized.
3. Source: B3.
4. Ibid.
5. Source: World Bank, 2019.

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